

Internal Revenue Service
memorandum

CC:TL-N-6652-88
Br4:RBWeinstock

date: JUN 14 1988

to: District Counsel, [REDACTED]
Attn. [REDACTED]

from: Director, Tax Litigation Division

subject: [REDACTED]

This is in response to your request for technical advice dated May 27, 1988.

ISSUE

Whether amounts received by petitioner from the [REDACTED] [REDACTED] was excludable from gross income under I.R.C. § 117 as a fellowship or scholarship because it falls within Rev. Rul. 75-280, 1975-2 C.B. 47.

BACKGROUND

In [REDACTED], petitioner [REDACTED] enrolled in the [REDACTED]. He was offered a fellowship by the [REDACTED] which is part of the State of [REDACTED]. The Institute is located on the University campus and operates in a cooperative capacity with the University. The head of the Institute is also a University professor. During [REDACTED] petitioner received \$ [REDACTED] and in [REDACTED] petitioner received \$ [REDACTED] from [REDACTED].

In [REDACTED], a memorandum of understanding was executed by the [REDACTED], the Chairman of the Doctoral Committee and the petitioner. The Memorandum of Understanding indicates that the [REDACTED] has been conducting the program of joint sponsorship and training for a period of [REDACTED] years. More than 9 out of 10 fellowship arrangements have paid off in a research job and thesis well done in a reasonable time and at moderate expense. The state has also obtained through the program better qualified personnel in its [REDACTED] programs first by contributing to their education and training and finally by holding them in permanent jobs.

According to the Memorandum of Understanding, basic considerations of the fellowship include 1) the State has a

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particular problem or problem area which must be studied and which can be solved within the time and effort available in a one-man fellowship; 2) a graduate student who has gained admission to a graduate school is available and interested in working on the problem; and 3) the University must find a particular problem suitable for its doctoral program. The student is under the supervision of [REDACTED].

The Memorandum of Understanding also provides that the student is a state civil service employee and must obtain approval to engage in other civil service employment. He is classified as Student Assistant [REDACTED] and his initial pay is 65% of the top of the Student Assistant [REDACTED] grade. After completion of the formal course work and exams, the student is paid 80% of the top of the Student Assistant [REDACTED] grade level. The student receives subsistence and travel expenses from [REDACTED] which also provides the student with a state-owned car and equipment for field work on his research topic. All expenses are paid in accordance with departmental regulations.

At the appeals level, it was determined, from conversations with state personnel employees, that the student is treated like a regular state employee with regard to attendance records, service ratings, annual sick leave, retirement pension and is subject to standard travel regulations. You were not able to verify this information. 1/

Petitioner had discretion subject to the directions of the faculty advisor and committee to choose the specific study areas. Petitioner, however, has stated that [REDACTED] chose the topic of his research, "[REDACTED]". [REDACTED] is a form of [REDACTED] with the State has great interest in because it provides a high quality [REDACTED] through [REDACTED]s [REDACTED] and their tributaries. The State of [REDACTED] has developed and maintains extensive [REDACTED] systems in a [REDACTED] program which provides large numbers of young [REDACTED] each year for planting.

Petitioner's status as a research assistant terminated in [REDACTED] with his appointment as a fisheries biologist with the [REDACTED]. As a student assistant, his duties and responsibilities required him to perform technical, professional or administrative work in the field of his specialization or to work on his graduate degree. The civil service position states that the work of a student assistant is performed under the direct supervision of technical, professional, or management personnel. The [REDACTED]

1/ [REDACTED], in telephone conversations with the National Office has mentioned that the actual arrangements changed in later years. In later years the fellowship was received from the University and not [REDACTED] and recipients were not civil service employees.

paid all of petitioner's research costs originally estimated to exceed \$ [REDACTED].

Petitioner's trial memorandum indicates that he will testify that he was subject to supervision only by his Doctoral Committee and was neither supervised nor assigned any duties by [REDACTED] [REDACTED] of the [REDACTED] and [REDACTED] will testify that the Memorandum of Understanding relied upon by the Commissioner is in error or obsolete in many important respects. Finally, [REDACTED] will testify as to the administrative details of the fellowship, including the fact that petitioner did not receive normal employment fringe benefits. Petitioner's trial argument is that the fellowship's primary purpose is for the furthering of the education and training of the taxpayer and not in payment of services.

ANALYSIS

For the years at issue I.R.C. § 117(a)(1) provided that gross income does not include any amount received as a scholarship at an educational organization described in I.R.C. § 170(b)(1)(A)(ii) or as a fellowship grant. I.R.C. § 117(b)(1) provided that for an individual who is a candidate for a degree at an educational institution described in section 170(b)(1)(A), the exclusion from gross income shall not apply to that portion which represents payment for teaching, research, or other services in the nature of part-time employment required as a condition to receiving the scholarship or the fellowship grant. See also Treas. Reg. §§ 1.117-1(a), 1.117-2(a) and 1.117-4(c).

Treas. Reg. § 1.117-3(c) defines a fellowship grant as "an amount paid or allowed to, or for the benefit of, an individual to aid him in the pursuit of study or research." Whether a particular payment satisfies the general definition depends upon the nature of the activities carried on by the recipient, and the purpose of the grantor in making the payment. If a payment represents compensation for employment services or services which are subject to the supervision of the grantor, it is not excludable as a fellowship grant.

Rev. Rul 75-280, 1975-2 C.B. 47, held that stipends received by graduate students who performed certain research services would be regarded as a scholarship or fellowship grant and not be regarded as part-time employment where the taxpayer was (1) a candidate for a degree at an educational institution, (2) the taxpayer performed research, training, or other services for the institution that satisfied then existing specifically stated requirements for the degree, and (3) equivalent services were required of all candidates for the degree.

Where the three conditions were met, Rev. Rul. 75-280 stated that the Internal Revenue Service would assume that the amounts paid were for the primary purpose of furthering the education and training of recipients in their individual capacity. The ruling stated however that the Service will not assume the primary purpose test was satisfied to the extent (1) the taxpayer performs services in excess of those required for the degree; (2) the taxpayer performs research, teaching or other services for a party other than the educational institution; (3) the grant is made because of past services or conditioned on performance of future services; or (4) the degree requirements, or the nature and extent of the work that is approved as satisfying the degree requirements, are not reasonably appropriate to the particular degree.

The issue of the section 117 exclusion and the application of Rev. Rul. 75-280 has received a certain amount of recent public scrutiny. A litigation guideline memorandum was recently issued stating that Rev. Rul. 75-280 is to be followed. This is consistent with Commissioner Gibbs' recent response to Senator Chiles of Florida who had inquired about a number of stipend cases involving graduate students. The Service also issued a news release on March 30 (IR-88-65) stating that if the three part test of Rev. Rul. 75-280 is met, the Service will assume that the amount of a stipend was for the primary purpose of furthering the taxpayer's education or training and is excludable from gross income.

The facts of the present case are distinguishable from those in Rev. Rul. 75-280. While petitioner was a degree candidate at the University of [REDACTED], the Services were performed for (and the fellowship was paid by) [REDACTED]. Rev. Rul. 75-280 specifically provides (as we have noted) that it will not be assumed that the primary purpose test is satisfied if the taxpayer performs research or other services for a party other than an educational institution. Therefore, litigation of this case is not foreclosed by Rev. Rul. 75-280.

While Rev. Rul 75-280 does not apply, this does not mean that petitioner fails to satisfy the primary purpose test. ^{2/} The question remains as to whether petitioner was paid to enable him to perform his research in his individual capacity or compensate him for past, present or future services. Adams v.

^{2/} While the regulations and some courts have adopted the primary purpose test, Hembree v. United States, 464 F.2d 1262, 1264 (4th Cir. 1972), the Supreme Court set forth the quid pro quo test in Bingler v. Johnson, 394 U.S. 741 (1969), under which if there is any substantial quid pro quo, i.e., compensation for services, the payments cannot qualify for exclusion from income as "fellowship funds".

Commissioner, 71 T.C. 477, 486 (1986); Zolnay v. Commissioner, 49 T.C. 389, 396 (1968); Smith v. Commissioner, T.C. Memo. 1986-274; Chen v. Commissioner, T.C. Memo. 1979-407. This is a question of fact. Zolnay v. Commissioner, 49 T.C. at 395.

Certain aspects of the relationship of petitioner to [REDACTED] indicates that it was a pay-for-work arrangement such as managerial supervision, State of [REDACTED] employee status, restrictions on other employment and certain benefits such as sick leave and participation in the state pension plan. These factors are indicative of an employment relationship, notwithstanding the fact that petitioner and the university exercise certain elements of control in dealing with the fellowship. Petitioner's trial memorandum indicates that he will present testimony to rebut certain parts of the Memorandum of Understanding, including the fact that petitioner allegedly did not receive certain employee benefits. 3/ Petitioner will also introduce testimony to show his control over his research as well as the actual dissertation and the 'lack' of a quid pro quo for [REDACTED]. 4/ Thus, there are facts which support petitioner's claim that the amounts received were excludable fellowship payments. It is no means certain that respondent will prevail. Cf. , Smith v. Commissioner, T.C. Memo. 1986-274; Chen v. Commissioner, T.C. Memo. 1979-407. 5/

In order to assist you in the preparation of briefs for this case, we have enclosed copies of the appellate briefs in Rockswold v. United States and Reese v. Commissioner. We have

3/ You have stated that petitioner was not entitled to some employee benefits because he was not in a career status while a fellowship recipient.

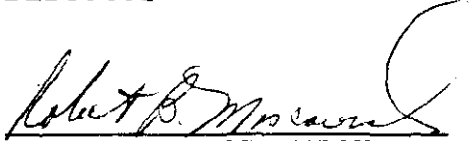
4/ It is our understanding (from discussions with Dennis Driscoll) that petitioner's fellowship proposal placed great stress on the benefits to [REDACTED] and the State of [REDACTED] that the research would provide. Given the fact that the topic of [REDACTED] was suggested to him, and the value of the study to [REDACTED], a very definite benefit was received by [REDACTED] and the State for which [REDACTED] had made the payments to petitioner.

5/ Your office advised us that the Service made a settlement offer which would have conceded one-half of the deficiency. Petitioner turned this offer down.

also enclosed a copy of Newman v. Commissioner, T.C. Memo. 1988-147, a recent opinion involving the section 117 exclusion. If you have any questions on the above or require further assistance, please contact Ronald Weinstock at (FTS) 566-3345.

MARLENE GROSS
Director

By:


ROBERT B. MISCAVICH
Sr. Technician Reviewer
Branch No. 4
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Enclosures:
Rockswold brief
Reese Brief
Newman opinion